April 4, 2024

Kroll Lowers Its Normalized Risk-Free Rate for Germany from 3.0% to 2.5%, Effective March 31, 2024

Executive Summary

Kroll regularly reviews fluctuations in global economic and financial market conditions that may warrant changes to our equity risk premium (ERP) and accompanying risk-free rate recommendations. The risk-free rate and ERP are key inputs used to calculate the cost of equity capital in the context of the Capital Asset Pricing Model (CAPM) and other models used to develop discount rates. We also update country risk data on a quarterly basis for 175+ countries using various models.

Kroll issued a client alert on February 8, 2024 indicating that:

- The Kroll normalized risk-free rate of 3.0% for Germany could be lowered in the near future.
- The Kroll Recommended Eurozone ERP remained in the range of 5.5% to 6.0%, but based on the prevailing economic and financial market conditions, we believed that a 5.5% ERP (i.e., toward the lower end of the range) was more appropriate.

We also noted that short-term and long-term inflation expectations in Germany and the Eurozone had been declining at a much faster pace than initially anticipated by economists and the European Central Bank (ECB). Since issuing that update, inflation readings in the region continued to surprise on the positive side (i.e., inflation rate dropped more than estimated), leading the ECB to lower its inflation expectations once again. Based on these trends and updated long-term inflation expectations, **we are lowering the German normalized risk-free rate from 3.0% to 2.5% when developing EUR-denominated discount rates as of March 31, 2024, and thereafter,** until further guidance is issued. In addition, **we continue to recommend using the spot 15-year German government bond yield as the proxy for the risk-free rate if the prevailing spot yield as of the valuation date is higher than our normalized German risk-free rate of 2.5%**. While the new recommendation is effective for valuation dates starting on March 31, 2024, current economic conditions suggest that the new guidance may be already appropriate earlier in March.

The new German risk-free rate guidance is to be used with the Kroll Recommended Eurozone ERP of 5.5% to 6.0%. Based on current economic and financial market conditions, we continue to believe that an **ERP toward the lower end of this range (i.e., a 5.5% ERP) is likely more appropriate**. Using the bottom of the ERP range in conjunction with the new normalized risk-free would imply a Eurozone base cost of equity capital from a German investor perspective of 8.0% (= 2.5% + 5.5%). Incremental country risk adjustments for other Eurozone countries with a sovereign debt rating below AAA may be appropriate.

Additional guidance on UK ERP and volatility of current spot yields on government bonds is also provided.

Cost of Capital Recommendations

Eurozone (From the Perspective of a German Investor)

Recent inflation readings in the Eurozone and Germany have declined at a much faster pace than initially anticipated by economists and the ECB. Long-term inflation expectations have also declined significantly in both Germany and the overall Eurozone. In its March 2024 macroeconomic update, the ECB revised the Eurozone's inflation forecasts down considerably relative to its December 2023 update. When compared to its September 2023 update, the downward revisions were even more pronounced. For example, the ECB forecast for 2024 headline inflation declined by 90 basis points from September 2023 to March 2024.[1] In light of these developments, it is likely that the ECB will start cutting its policy rate sometime in mid-2024. Based on these trends and updated long-term inflation expectations for Germany, we are lowering our German normalized risk-free rate from 3.0% to 2.5% when developing EUR-denominated discount rates as of March 31, 2024, and thereafter, until further guidance is issued. In addition, we continue to recommend using the spot 15-year German government bond yield as the proxy for the risk-free rate if the prevailing spot yield as of the valuation date is higher than our normalized German risk-free rate. In fact, in recent days the 15-year Germany government spot yield has been hovering around the 2.5% normalized rate.[2]

In addition, while the Eurozone economy has not been as resilient as in the U.S., real GDP growth in 2023 ended in a much better place than originally projected at the beginning of the year. The job market continues to be relatively strong, and economic recovery is expected to continue, although at a slow pace in some of the countries within the region (e.g., Germany). The increased prospects of ECB rate cuts starting in mid-2024 have boosted European equity markets. The STOXX Europe 600, the pan-European index, has recently reached new record highs, which had not occurred since early 2022. Benchmark stock indices in some of the countries in the Eurozone have also continued to achieve new records, such as the CAC-40 in France, the DAX in Germany, the FTSE-MIB in Italy and the IBEX-35 in Spain.

While the Kroll Recommended Eurozone ERP remains in the range of 5.5% to 6.0%, based on current economic and financial market conditions, we continue to believe that a 5.5% ERP (i.e., toward the lower end of the range) is more appropriate when developing EUR-denominated discount rates as of February 8, 2024, and thereafter, until further guidance is issued. This guidance was developed from a German investor perspective. Incremental country risk adjustments for other Eurozone countries with a sovereign debt rating below AAA may be appropriate.

Please note that this information does not supersede Germany's IDW (Institut der Wirtschaftsprüfer) guidance for projects that will be reviewed by German auditors or regulators.

For the underlying data support for the latest guidance, click here.

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1 For the latest and past macroeconomic projections issued by the ECB staff, visit: https://www.ecb.europa.eu/mopo/strategy/ecana/html/table.en.html.

2 Source: Interest rates on listed German federal securities (calculated using the Svenson method), Deutsche Bundesbank.

United Kingdom

The Kroll Cost of Capital Navigator contains historical ERP against long-term government bonds for various countries, including the UK. Historical ERP data for the UK begins in 1900 and is available for every year since then until the present.[3] However, Kroll does not currently have an official ERP recommendation for the UK, which takes into consideration both historical and forward-looking indications.

In general, the country's high exposure to Europe, especially since the Russia-Ukraine war, indicates that UK equity market risks are more aligned with Europe than they are with the U.S.

Nonetheless, there are incremental downside risks in 2024 for the UK relative to the Eurozone. Since inflationary pressures began in 2021 (in the aftermath of the pandemic), the UK saw higher peak inflation (11.1%) than in other major developed economies (e.g., 10.6% in the Eurozone and 9.1% in the U.S.). While the UK process of disinflation is well in progress, it has been generally slower than in other developed economies. For instance, 12-month headline inflation stood at 4.0% in January 2024 (twice the Bank of England's target) vs. 3.1% in Germany and the Eurozone (the ECB's target inflation is also 2.0%). This suggests the Bank of England has less monetary policy flexibility than the ECB, and it may start cutting policy interest rates later than its peers. The UK experienced a shallow recession in the last half of 2023, but economic recovery is projected to be sluggish, with growth expectations for 2024 more subdued than in the Eurozone. Finally, the UK is heading into a parliamentary election later in 2024, and the current government must balance the need to offer voters an incentive to keep them in power while avoiding a replay of the turbulence created by former Prime Minister Liz Truss' short-lived mini-budget. With this backdrop, the UK stock market has seen little price appreciation over the last 12 months, in stark contrast with other large European stock markets, several of which have experienced year-on-year gains approaching or exceeding 20%. Valuation professionals should consider these additional risks when selecting a UK ERP.

Volatility of Current Spot Yields on Government Bonds

As investors attempt to predict the pace and magnitude of potential rate cuts by major central banks, we continue to observe high levels of volatility in spot yields of government bonds of major economies. Long-term bonds yields may continue to fluctuate considerably in the near future, before stabilizing. During these periods, valuation professionals may need to consider using a moving average of spot yields to mitigate the impact of this volatility in their valuation analyses (e.g., weekly, or monthly averages).

Please contact our support team with any questions: costofcapital.support@kroll.com

[3] For additional details on the data sets included in the International Cost of Capital module within the Kroll Cost of Capital Navigator, visit: https://www.kroll.com/en/cost-of-capital/international-cost-of-capital.